

**Improvements Are Needed in the Earned
Income Credit Recertification Program**

December 2000

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This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

December 29, 2000

MEMORANDUM FOR COMMISSIONER, WAGE AND INVESTMENT DIVISION

A handwritten signature in black ink, reading "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Improvements Are Needed in the Earned
Income Credit Recertification Program

This report presents the results of our review of the Earned Income Credit (EIC) Recertification Program. In summary, we identified conditions in the EIC Recertification Program that adversely affected the Internal Revenue Service's (IRS) ability to safeguard revenue and ensure taxpayer rights with the least amount of burden to taxpayers. These conditions included: the IRS did not always remove recertification indicators accurately, some suspended refunds were not released timely, recertification audits were not always timely processed, not all recertification determinations were accurate, taxpayer correspondence could be improved, and the IRS could enhance the Recertification Program.

We recommended that the IRS ensure that employees process recertification cases accurately and timely. Specifically, the IRS should ensure that recertification indicators are accurately removed, audits are timely and accurately completed, taxpayer correspondence is accurate and complete, and the quality review process is improved. In addition, the IRS should consider modifying the Program to ensure that taxpayers are recertified for the reasons for which their EIC was originally denied.

The IRS agreed with 10 of our 12 recommendations. Their comments are incorporated in the report, and the full text of their response is included in Appendix VI. In addition, the IRS responded that its Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) would address one of the recommendations, along with its related outcome measure. As of December 20, 2000, we had not received this additional response.

The IRS did not agree with our recommendation to improve its quality review process. Instead, the IRS indicated that it would rely on its revised procedures and training to ensure that employees remove indicators when appropriate. While the IRS does have a quality assurance process in place, we believe that it should be improved to identify error trends or patterns specifically related to recertification cases. Also, while the IRS agreed with our recommendation to improve taxpayer correspondence used in the Recertification Program, the response did not address four of the six letters requiring clarification.

The IRS agreed with most of the outcomes presented in this report. However, it disagreed with the number of taxpayers affected by not properly reversing the recertification indicator (1,646 v. 11,400). During our audit, we provided the IRS with the methodology, extract criteria, and actual cases in our sample to support our outcome measure. Our review of the IRS' analysis showed that its case selection criteria excluded several categories of closed recertification cases. For example, the IRS' selection criteria did not include Tax Year 1997 returns, Tax Year 1998 returns with non-examined disposal codes, or Tax Year 1998 returns closed as other than "No Change."¹

Copies of this report are also being sent to the IRS managers who are affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions, or your staff may call Walter Arrison, Associate Inspector General for Audit (Wage and Investment Income Programs), at (770) 936-4590.

¹ Examination case did not necessitate the issuance of a report because there were no adjustments or no changes in tax liability.

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Executive Summary

The Congress established the Earned Income Credit (EIC) in 1975 to help alleviate poverty and provide work incentives to low income taxpayers. The EIC affects a significant number of taxpayers, as demonstrated by the large number of taxpayers claiming the credit. For example, 19.4 million taxpayers claimed \$30.6 billion in EIC on their 1998 tax returns.¹

Taxpayers can qualify for the EIC in two ways. The first involves “child-related” EIC, where taxpayers meet income requirements and have either one or two qualifying children. A qualifying child is a child (adopted, step, grand, foster) under age 19 (24 for full-time students). Taxpayers without qualifying children may qualify for “income-only” EIC if their income is below a certain level.

Historically, the EIC has been subject to abuse by taxpayers claiming credits they are not entitled to receive. As a result, the Congress passed legislation² in 1997 requiring taxpayers whose EIC was denied during audits to prove their eligibility for the credit before they could receive the EIC again. This law is effective for tax years beginning after December 31, 1996.

In response to this legislation, the Internal Revenue Service (IRS) implemented the EIC Recertification Program in January 1999. When the IRS denies the EIC during an audit, a recertification indicator is placed on the taxpayer’s account preventing the taxpayer from receiving future EIC unless the IRS and/or the taxpayer takes appropriate actions.

The objective of this review was to determine whether the IRS’ EIC Recertification Program effectively addressed this legislation.

Results

The IRS’ EIC Recertification Program should reduce the amount of incorrect EIC allowed by the IRS. We estimate that, as of September 30, 1999, the IRS properly placed recertification indicators on 336,000 taxpayer accounts while denying, during audits, an estimated \$620 million in EIC claims. While this is a noteworthy accomplishment, significant improvements are needed for the entire Program to operate effectively. Our review identified the following conditions that adversely affected the IRS’ ability to safeguard revenue and ensure taxpayer rights with the least amount of burden to taxpayers:

¹ Processed as of December 26, 1999.

² Taxpayer Relief Act of 1997, 26 U.S.C. § 24.

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- The IRS did not always remove recertification indicators accurately.
- Some suspended refunds were not released timely.
- Recertification audits were not always timely processed.
- Not all recertification determinations were accurate.
- Taxpayer correspondence could be improved.
- The IRS could enhance the Recertification Program.

These conditions occurred because the IRS did not always implement effective procedures for its employees to follow when processing Recertification Program cases. The IRS' quality assurance process also did not provide accurate feedback on the Program's performance. As a result, some taxpayers encountered delayed refunds, unnecessary audits, or non-receipt of their EIC. Other taxpayers may have received an EIC they were not entitled to. In addition, some taxpayers were recertified but not for the reason for which their EIC was initially denied.

The Internal Revenue Service Did Not Always Remove Recertification Indicators Accurately

The use of the recertification indicator is an important part of the IRS' process for ensuring that taxpayers prove their EIC eligibility. However, the IRS did not have a consistent process for ensuring that indicators were accurately removed. As a result, an estimated 11,400 taxpayers may have their future EIC claims incorrectly denied or audited because the indicators were not removed after the IRS allowed the EIC claimed by taxpayers. In addition, an estimated 4,100 taxpayers had their indicators removed incorrectly, which could result in these taxpayers receiving an EIC they are not entitled to on subsequent returns.

Some Suspended Refunds Were Not Released Timely

The IRS can suspend refunds while the EIC audit actions are pending. We estimate that the IRS had taken action to suspend any refunds on 91,000 Tax Year 1998 accounts that either had not been audited or for which the audits had been closed as of September 1999. To determine whether refunds were released timely, we selected a random sample of 200 of these accounts. Our analysis showed that 43 percent of these accounts had refund delays that ranged from 2 to 40 weeks and averaged 9 weeks.

Recertification Audits Were Not Always Timely Processed

The IRS should expeditiously complete Recertification Program audits so that taxpayers are brought into compliance with the EIC regulations, taxpayers who are entitled to their refunds do not have refunds unnecessarily delayed, and taxpayers do not file subsequent year returns prior to the audits being completed. Our analysis of selected EIC

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recertification audits at 3 IRS processing centers found that 57 percent of the returns had delays that ranged from 2 to 29 weeks and averaged 8 weeks.

Not All Recertification Determinations Were Accurate

Taxpayers who were previously denied the EIC are required to submit Information To Claim Earned Income Credit After Disallowance (Form 8862) with the next tax return they file that claims the EIC. The IRS should send returns with this form to the Examination function to determine whether the taxpayers are entitled to the credit. Our review identified indications that the IRS allowed the EIC to taxpayers who did not submit sufficient documentation to prove they were entitled to the credit.

Taxpayer Correspondence Could Be Improved

Correspondence used in the Recertification Program should explain how the Program works and what is required for taxpayers to prove their EIC eligibility. Some of the letters were incomplete or contained incorrect information, while others did not include important information about the Program. Additionally, letters were not sent to advise taxpayers that they might be entitled to income-only EIC.

The Internal Revenue Service Could Enhance the Recertification Program

In March 2000, the IRS issued procedures stating that qualified taxpayers who claimed income-only EIC and filed Forms 8862 would be considered recertified. Implementing these procedures will cause taxpayers to be recertified for reasons other than the initial EIC denial reason and enable taxpayers to receive the EIC related to a qualifying child in subsequent years without being subjected to recertification audits.

Summary of Recommendations

To improve the Recertification Program, the IRS should ensure that employees process recertification cases accurately and timely. Specifically, it should ensure that recertification indicators are accurately removed, audits are timely and accurately completed, taxpayer correspondence is accurate and complete, and its quality review process accurately assesses the Program's performance. In addition, the IRS should consider modifying this Program to ensure that taxpayers are recertified for the reasons for which their EIC was originally denied.

Management's Response: The IRS agreed with 10 of our 12 recommendations. It did not agree with our recommendation to improve its quality review process. Instead, IRS indicated that the number of closed recertification cases is 1.4 percent of the total EITC cases closed and it would not be unusual that only five errors were identified nationwide.

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In addition, the IRS responded that the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) would address recommendation 12 of this report, along with its related outcome measure. As of December 20, 2000, we had not received this additional response. The IRS' comments are incorporated in the report where appropriate, and the full text of the response is included as Appendix VI.

Office of Audit Comment: While the IRS does have a quality assurance process in place, we believe that it should be improved to identify error trends or patterns specifically related to recertification cases. Also, while the IRS agreed with our recommendation to improve the taxpayer correspondence used in the recertification program, its response did not address four of the six letters requiring clarification.

While the IRS agreed with most of the outcomes presented in this report, it disagreed with the number of taxpayers affected by not properly reversing the recertification indicator (1,646 v. 11,400). We provided the IRS with the methodology, extract criteria, and actual cases in our sample to support our outcome measure. Our review of the IRS' analysis showed that its case selection criteria excluded several categories of closed recertification cases. For example, the IRS' selection criteria did not include Tax Year 1997 returns, Tax Year 1998 returns with non-examined disposal codes, or Tax Year 1998 returns closed as other than "No Change."³

³ Examination case did not necessitate the issuance of a report because there were no adjustments or no changes in tax liability.

Objective and Scope

The objective of our audit was to determine whether the IRS effectively addressed legislation requiring taxpayers to prove their eligibility for the EIC after it was previously denied during an audit.

This review was conducted as part of the Treasury Inspector General for Tax Administration's (TIGTA) Fiscal Year 2000 audit plan. Our overall objective was to determine whether the Internal Revenue Service (IRS) effectively addressed legislation requiring taxpayers whose Earned Income Credit (EIC) is denied during an audit to prove their eligibility for the credit before they receive it again. To accomplish this objective, we determined whether the IRS:

- Established an effective recertification process to address the legislation and clearly defined the process in regulations and procedures.
- Used correspondence that clearly communicated with taxpayers about this process.
- Established accurate indicators on taxpayers' accounts that prevented taxpayers from receiving the EIC and then removed the indicators after taxpayers proved their eligibility.
- Processed taxpayers' EIC eligibility claims in a timely and accurate manner.

This audit was conducted at the IRS National Headquarters and the Austin, Fresno, and Memphis Processing Centers. We performed our audit from December 1999 through April 2000 in accordance with *Government Auditing Standards*.

To conduct our review, we obtained a database containing 10 percent of the national recertification accounts as of September 30, 1999. Using this database, we analyzed the information to identify recertification conditions. When appropriate, we estimated nationwide figures based on the results of our analysis of the 10 percent database.

At the start of our review, the IRS had not fully implemented two additional recertification indicators to address instances where the EIC was denied due to the

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taxpayers' (1) reckless or intentional disregard for the law or (2) fraudulent claim of the credit. We did not conduct any tests regarding these two indicators.

Details of our audit objective, scope, and methodology are presented in Appendix I. Major contributors to this report are listed in Appendix II.

Background

The Congress established the EIC in 1975 to help alleviate poverty and provide work incentives to low income taxpayers. The EIC affects a significant number of taxpayers, as demonstrated by the large number of taxpayers claiming the credit. About 19.4 million taxpayers claimed EIC of \$30.6 billion on their 1998 tax returns.¹

There are two ways taxpayers can qualify for the EIC. The first is with at least one qualifying child, and the second is with low income without a qualifying child. Approximately 19.4 million taxpayers claimed EIC totaling \$30.6 billion on their 1998 tax returns.

There are two ways that taxpayers can qualify for the EIC. The first involves taxpayers who have qualifying children. In 1998, the EIC amount for these taxpayers ranged from \$2 to \$3,756, depending on their income and whether they had 1 or 2 qualifying children. A qualifying child is a child (adopted, step, grand, foster) under age 19 (24 for full-time students). In this report, we are calling this "child-related" EIC. As of December 26, 1999, approximately 16.1 million taxpayers had claimed child-related EIC on their 1998 tax returns.

Taxpayers without qualifying children may also qualify for the EIC if their income is below a certain level. In 1998, taxpayers with income from \$1 to \$10,029 were eligible to receive an EIC ranging from \$1 to \$341. In this report, we are calling this "income-only" EIC. As of December 26, 1999, approximately 3.3 million taxpayers had claimed income-only EIC on their 1998 tax returns.

Historically, the EIC has been subject to abuse by taxpayers who claim an EIC they are not entitled to

¹ Processed as of December 26, 1999.

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receive. As a result, the Congress passed legislation² in 1997 that is applicable for tax years beginning after December 31, 1996. This legislation requires taxpayers whose EIC was denied during audits to prove their eligibility for the credit before they can receive the EIC again.

Results

In response to this legislation, the IRS established the EIC Recertification Program. This Program was designed to prevent taxpayers whose EIC was denied during an audit from receiving the credit again unless they prove their eligibility for it.

The IRS established the EIC Recertification Program in response to legislation. However, the Program needs to be improved to enhance the safeguarding of revenue, help ensure the protection of taxpayer rights, and reduce burden to taxpayers.

The EIC Recertification Program should reduce the amount of incorrect EIC allowed by the IRS. We estimate that, as of September 30, 1999, the IRS properly placed recertification indicators³ on 336,000 taxpayer accounts while denying an estimated \$620 million in EIC claims during audits. While this is a noteworthy accomplishment, significant improvements are needed for the entire Program to operate effectively.

Our review identified the following situations that adversely affected the IRS' ability to safeguard revenue and ensure the protection of taxpayer rights with the least amount of burden to taxpayers.

- The IRS did not ensure that recertification indicators were always accurately removed from taxpayers' accounts.
- Refunds suspended while the IRS audited EIC returns were not always timely released.
- Recertification audits were not always processed in a timely manner.

² Taxpayer Relief Act of 1997, 26 U.S.C. § 24.

³ If the IRS denies the EIC in whole or in part during an audit, it should place a recertification indicator on the taxpayer's account. This indicator should prevent a taxpayer from receiving the EIC in the future unless the IRS and/or the taxpayer take other actions.

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- Recertification determinations were not always accurate.
- Correspondence to taxpayers about the recertification process was not always clear or was not sent.
- The IRS could enhance the Recertification Program to better protect revenue.

These conditions occurred because the IRS did not always implement effective procedures for its employees to follow when processing Recertification Program cases. The IRS' quality assurance process also did not provide accurate feedback on the Program's performance. As a result, some taxpayers encountered delayed refunds, unnecessary audits, and non-receipt of their EIC. Other taxpayers may have received an EIC they were not entitled to receive. In addition, taxpayers were being recertified but not for the reason their EIC was initially denied.

Although the Program addressed Congressional concerns, implementation problems occurred

During January 1999, the IRS implemented the Recertification Program to address legislation requiring certain taxpayers to prove their eligibility for the EIC. The Program included the following positive attributes:

- If the IRS denies the EIC in whole or in part during an audit, it should place a recertification indicator on the taxpayer's account. This indicator should prevent the taxpayer from receiving the EIC in the future unless the IRS and/or the taxpayer takes other actions.
- Taxpayers denied the credit are required to submit Information To Claim Earned Income Credit After Disallowance (Form 8862) with the next tax return they file that claims the EIC. After receiving this form, the IRS should determine whether the taxpayer is eligible for the credit. If the EIC is allowed, the taxpayer is considered recertified, and the IRS should remove the indicator. These taxpayers are

The Recertification Program includes placing an indicator on the taxpayer's account when the EIC is denied or reduced during an audit. Taxpayers should be recertified before receiving the EIC again.

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not required to file Forms 8862 with subsequent tax returns.

- If taxpayers claim the EIC without filing Forms 8862, the IRS should deny the EIC when it processes the tax returns.
- Various IRS letters should inform taxpayers about the recertification process.

As previously discussed, the IRS placed a significant number of recertification indicators on taxpayers' accounts. We estimate that, as of September 1999, 32,600 of these taxpayers filed Forms 8862 with their tax returns.

The establishment of the Recertification Program prevented some taxpayers from receiving an EIC they were not entitled to. However, not all aspects of the Program were effectively implemented. In general, problems were identified with removing the indicators, not releasing refunds timely, untimely audits, inaccurate determinations to allow the EIC, and unclear correspondence to taxpayers.

The Internal Revenue Service Did Not Always Remove Recertification Indicators Accurately

The use of the recertification indicator is an important part of the IRS' process for ensuring that taxpayers prove their EIC eligibility. However, the IRS did not have a consistent process for ensuring that indicators were accurately removed. As a result, some taxpayers may have their future EIC claims incorrectly denied or audited, while others may incorrectly receive this credit.

The IRS did not always remove recertification indicators after allowing the EIC

As of September 1999, the IRS had allowed the EIC for an estimated 19,200 taxpayers included in the Recertification Program.

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The IRS did not remove the indicator for an estimated 11,400 accounts when the EIC was allowed.

However, the IRS did not remove the recertification indicator for an estimated 11,400 (59 percent) taxpayers. This problem occurred at each of the 10 IRS processing centers and resulted in non-removal rates ranging from 30 percent to 90 percent. (Example 1 in Appendix V illustrates this condition.)

The IRS incorrectly removed some recertification indicators

As of September 1999, the IRS had removed an estimated 11,500 indicators from taxpayers' accounts. However, the IRS incorrectly removed the indicator 36 percent of the time, affecting an estimated 4,100 taxpayers in the following situations:

- An estimated 3,100 taxpayers had the indicators removed, although the IRS did not audit the returns and did not allow any EIC.
- An estimated 500 taxpayers had child-related EIC allowed, although the returns did not have the required audits.
- An estimated 200 taxpayers had child-related EIC denied, but the indicators were still removed.
- An estimated 300 taxpayers had their EIC denied during audits of their 1997 tax returns. These audits were completed after the taxpayers had already filed their 1998 tax returns. The IRS subsequently allowed the EIC for the 1998 tax returns and removed the indicators. However, IRS regulations provided that taxpayers in this situation should not be considered recertified until they submitted Forms 8862 with their 1999 tax returns.

The processing center that had the highest number of Recertification Program taxpayers removed the majority of the 4,100 indicators.

These conditions occurred because procedures were ineffective

We identified several conditions that contributed to the problems described:

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The problems of not removing or incorrectly removing the indicators can be attributed to the recertification procedures and the quality review process.

- The IRS did not provide its employees with clear procedures that addressed each of the situations when the indicator should be removed.
- The IRS did not ensure that the employees received, understood, and implemented recertification procedures. We interviewed 15 employees concerning these procedures. These conversations showed that some employees were confused as to when the recertification indicators should be removed. Some employees thought the indicator would be automatically removed in certain situations, while others did not know who had the responsibility for removing the indicators. Additionally, not all employees had the most current procedures.
- The IRS' quality review process did not identify and correct these conditions. For example, Quality Review identified, over a 7-month period, a total of 5 errors nationwide for not removing the indicator and no errors for incorrectly removing the indicator. Additionally, employees performing quality reviews at the three centers we visited did not have the current procedures for removing the indicator. Although we did not review cases to evaluate the quality review process, our audit results indicate that the process was not effective.

We advised the IRS about the problems we identified with the removal of recertification indicators, and it issued revised procedures in March 2000. However, these procedures lacked sufficient detail. For example, the procedures stated that:

The new procedures for removing the indicator lacked sufficient detail.

- Taxpayers would be considered recertified if they qualified for and claimed income-only EIC and filed Forms 8862. However, the procedures did not state what information and employee actions were necessary to prove taxpayers were qualified to receive the income-only EIC.
- The indicators would be removed at times when taxpayers did not claim the EIC—for example,

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taxpayers who filed Forms 8862 but did not claim any EIC.

Recommendations

1. The IRS should ensure that the recertification indicators on taxpayers' accounts are accurate. Accordingly, it should remove indicators from taxpayers' accounts if they have proven their EIC eligibility.

Management's Response: Management responded, "On January 1, 2000, we formalized EITC recertification procedures by including them in the IRM which is available to all EITC examiners on the Servicewide Electronic Research Program (SERP)."

2. The IRS should improve its quality review process to help ensure employees remove indicators when appropriate.

Management's Response: Management responded, "We conducted a quality review of 138 closed cases per month per site during Fiscal Year 2000. The total number of cases reviewed nationwide was approximately 16,500, or 2.9 percent of the total EITC closings. As of September 30, 1999, 572,695 EITC cases were closed nationwide and only 8,101 (1.4 percent) were recertification cases. As evidenced by our review, it would not be unusual that only five errors were identified nationwide. Therefore, we will not change our quality review process at this time, but rather we will rely on our revised procedures and training to ensure employees remove indicators when appropriate. If future reviews indicate problems, we will reconsider our quality review procedures."

Office of Audit Comment: Given the number of EITC closings and the importance of the recertification indicator, we believe the quality review process should be improved to identify error trends or patterns specifically for recertification cases.

3. The IRS should clarify the March 2000 procedures to specifically instruct employees as to what

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information and actions are needed to prove taxpayers are qualified to receive the income-only EIC. These procedures should also be clarified to ensure that taxpayers are not considered recertified when they file Forms 8862 but do not claim or receive an EIC.

Management's Response: Management responded, "We revised the March 2000 procedures and included them in the December 2000 IRM to specifically instruct employees as to what information and actions are needed to prove taxpayers are qualified to receive the income-only EITC. We also revised Letter 3094, EITC Credit Denied, in October 2000 to explain to taxpayers how to claim income-only EITC."

Some Suspended Refunds Were Not Released Timely

The IRS can suspend a taxpayer's refund until the IRS Examination function⁴ determines whether the EIC should be allowed. The IRS processing centers received weekly listings identifying taxpayers with suspended refunds. The IRS should release the refunds if the tax returns are not audited. For example, taxpayers would not be audited if they did not claim any EIC.

We selected and analyzed 200 accounts to determine whether suspended refunds had been timely released. The sample was taken from an estimated 91,000 Tax Year (TY) 1998 accounts, for which the IRS had taken action to suspend any refunds that did not have audits open as of September 1999.

From our sample of 200 accounts, we determined that 43 percent did not have refunds released timely.

We determined that the IRS did not timely release refunds on 86 (43 percent) of these 200 accounts, including 8 taxpayers (4 percent) who did not have their refunds released at all. Delays ranged from 2 to

⁴ The Examination function administers a nationwide audit program involving the selection and examination of various types of federal tax returns to determine correct liabilities of taxpayers.

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40 weeks and averaged 9 weeks. (Example 2 in Appendix V illustrates this condition.)

The majority of these late refunds involved taxpayers who did not claim the EIC on their 1998 tax returns. The IRS should have simply released the remaining withholding credit amounts. We reported this condition to IRS management on January 7, 2000.

The delayed refunds affected taxpayer entitlements to timely receive refunds. We identified several factors that contributed to this problem:

- The weekly listings used to determine whether to release the refunds or to conduct an audit did not contain all the accounts with suspended refunds because the IRS did not properly code the taxpayers' accounts to appear on the listings.
- The IRS procedures did not provide time frames for releasing suspended refunds. (The IRS subsequently issued procedures to address this issue.)
- The processing centers did not always timely complete the 1998 tax return audits.

Recommendations

4. The IRS should identify and resolve recertification accounts with incorrectly suspended refunds.

Management's Response: Management responded, "We requested a one-time extract to identify recertification accounts with suspended refunds and issued a Taxpayer Service Electronic Bulletin Board (TEBB) with instructions to exam personnel for working these cases. Additionally, a Request for Information Services (RIS) has been approved and tested for a monthly extract beginning January 1, 2001, of nonreversed refunds. This listing will be forwarded on a monthly basis to each Examination Branch for action and resolution."

5. The IRS should modify computer programs to ensure that the weekly listings include all applicable taxpayer accounts with suspended refunds.

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Management's Response: Management responded, "We corrected the programming by automating transaction code (TC) 424 and TC 810 on Pick-up cases. This will ensure weekly listings contain all accounts with suspended refunds. Instructions to Examination personnel to work the list within 5 business days were issued through a TEBB and are in IRM 21.8 dated December 1, 2000."

Recertification Audits Were Not Always Timely Processed

Not completing audits timely may delay taxpayer compliance and further delay refunds. The IRS should expeditiously complete Recertification Program audits so that:

- Taxpayers are brought into compliance with EIC regulations.
- Taxpayers who are entitled to their refunds do not have them unnecessarily delayed.
- Taxpayers do not file subsequent year returns prior to the audits being completed.

The IRS begins a recertification audit by sending the taxpayer a letter requesting additional information. At that time, the IRS also provides an audit report showing the proposed changes to the taxpayer's EIC amount. If the taxpayer agrees with the audit report, the EIC is denied and any remaining credits are released. If the taxpayer supplies sufficient proof to support the EIC claimed, the audit is closed. The refund is then released, and the recertification indicator should be removed.

If the taxpayer does not agree with the audit report or does not supply sufficient proof to support the EIC, the IRS sends the taxpayer a certified letter giving him/her 90 days to file a petition with the Tax Court. If the taxpayer does not respond to this letter within the time provided, the audit is closed and the EIC is denied.

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In our sample of 104 recertification audits, we identified timeliness problems with initial letters, certified letters, and responses to taxpayer correspondence.

We reviewed 104 EIC recertification audits at 3 of the IRS processing centers. In 59 (57 percent) instances, these audits had not been timely processed, with delays ranging from 2 to 29 weeks and averaging 8 weeks. (Example 3 in Appendix V illustrates this condition.)

These untimely processed audits had one or more of the following conditions:

- The IRS did not timely send the initial letters and audit reports. We used IRS guidelines and considered timely to be approximately 2 months from the time the tax returns were initially processed.
- The IRS did not timely send certified letters. These letters should be sent 60 days after the initial letters.
- The IRS did not timely respond to correspondence received from taxpayers. Generally, the IRS is required to respond to taxpayers within 30 days after receiving correspondence.

The following causes contributed to these untimely actions:

- The IRS did not have effective inventory controls to ensure that audits were started and completed timely. For example, 1 processing center had approximately 1,700 audits assigned to 1 employee. This included approximately 1,000 Recertification Program audits, most of which had not been started as of December 1999.
- Almost 30 percent of the audits were not controlled with the correct project codes used to identify recertification audits. This decreased the IRS' ability to effectively monitor Recertification Program inventories.

Recommendations

6. The IRS should ensure that inventory reports are effectively used to monitor and identify processing delays and provide timely feedback to offices where delays occur.

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Management's Response: Management responded, "The monthly extract detailed in the Corrective Action under Recommendation 4 will assist examiners in identifying and resolving processing delays. National Office will perform monthly oversight to ensure feedback is provided to offices where delays occur. Other monitoring tools are already in place. They include:

- The Report Generating Software (RGS) Case Summary Records are used to track cases. Managers have access to case summary records, can monitor individual employees and overall group inventory, and ensure that audits were completed timely.
 - Status workload reports generate every 2 weeks in each center. The parameters used on these reports allow management to timely control and move inventory.
 - Field Operations and National Office analysts perform monthly inventory oversight."
7. The IRS should use the correct project codes to identify recertification audits.

Management's Response: Management responded, "Project codes are automatically entered on master file when a return is filed claiming EITC and Form 8862 is attached. The IRS has corrected the programming on Pick-Up cases by automating TC 424, TC 810, and the project code, which will ensure all cases contain the correct code."

Not All Recertification Determinations Were Accurate

If a taxpayer claims an EIC, but does not file Form 8862 as required, the IRS should deny the credit when it processes the tax return. On the other hand, if a taxpayer claims the EIC and files Form 8862, the IRS should send the return to the Examination function to determine whether the taxpayer is entitled to the credit.

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The IRS did not always ensure taxpayers provided sufficient documentation before allowing the EIC.

We reviewed samples of audited and non-audited returns where the IRS allowed the EIC. We determined that the IRS did not always ensure that audited taxpayers provided sufficient documentation before allowing the taxpayers' EIC and exemptions and improperly allowed some credits on non-audited returns. Consequently, the Government's revenue will not be protected because some taxpayers will receive an EIC that they are not entitled to.

Sample of closed audits

When audits were conducted, the IRS requested additional information from taxpayers to support child-related EIC claimed and exemptions for children. Specifically:

- The IRS used Supporting Documents (Form 886H) to advise taxpayers of the different types of documentation the IRS would accept to prove that children lived with the taxpayers the required period of time. These documents included certain school, medical, or child care records. The documents should have included the child's name, address, and applicable dates and the name and address of the child's parent or guardian.
- The Form 886H also requested additional information to prove whether the taxpayers were entitled to tax deductions for children claimed as exemptions. This included copies of lease or rental agreements, the last mortgage statement, utility bills, and checks or receipts to support rent or mortgage payments and household expenses.

In our sample of 69 audited TY 1998 returns, we identified 22 returns where the IRS allowed the child-related EIC without sufficient documentation.

We reviewed a random sample of 69 TY 1998 returns that were audited. Thirty-five taxpayers simply agreed with the proposed EIC disallowance and did not submit any source documents. Nine other returns involved miscellaneous situations, such as taxpayers who agreed to the EIC disallowance after submitting insufficient documentation.

The remaining 25 returns had child-related EIC and exemptions for children allowed. However, the IRS did not always receive sufficient documentation from the

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taxpayers to prove their eligibility for the EIC or the exemptions. Specifically:

- Of the 25 returns, 22 (88 percent) did not have sufficient documentation to assure the IRS that the taxpayers were entitled to receive the EIC allowed, totaling approximately \$46,000. Of these 22 taxpayers, 6 did not provide any of the documentation requested by the IRS and the other 16 did not provide sufficient documentation to prove the children lived with the taxpayers for the required period of time.
- Of the 25 returns, 24 (96 percent) did not have sufficient proof from taxpayers to assure the IRS that the taxpayers were entitled to claim the children as exemptions for tax purposes. Of these 24 taxpayers, 9 did not provide any of the documentation requested and the other 15 did not provide sufficient documentation.

These conditions occurred, in part, because the IRS had not established minimum standards for auditors to use in determining the extent of source documents required before allowing the EIC and exemptions claimed by taxpayers.

Sample where EIC was allowed without audits

As of September 1999, the IRS allowed the EIC for an estimated 4,800 recertification cases without auditing the tax returns. We reviewed a random sample of 37 of these returns and determined that the IRS allowed some of these credits without first obtaining sufficient supporting documentation.

Most of these 37 recertification cases involved taxpayers who claimed the EIC on their returns but did not file Forms 8862 as required. When the IRS processed these tax returns, it denied the EIC and sent letters to the taxpayers explaining that they should file Forms 8862 to prove their eligibility for the credit. The taxpayers usually responded to the IRS' letter by asking for the credit but without providing documentation or the Forms 8862. (Example 4 in Appendix V illustrates this condition.)

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In our sample of 37 returns requiring recertification, we identified problems with the EIC being allowed without adequate documentation or without the required Forms 8862.

When the IRS received these responses, it evaluated the information provided by the taxpayers and allowed the EIC. However, in certain instances these determinations were not accurate.

- Of the 37 returns reviewed, the IRS allowed child-related EIC totaling approximately \$36,000 for 18 taxpayers. However, only 3 of the 18 returns were sent to the Examination function as required. In addition, the EIC was allowed without sufficient documentation. Sixteen of these 18 taxpayers did not provide any documentation, while the remaining 2 taxpayers provided incomplete documentation. The remaining 19 of 37 returns had income-only EIC claimed and allowed.
- Of the 37 taxpayers, only 6 (16 percent) filed the required Forms 8862 for Recertification Program taxpayers.

These problems occurred because the IRS did not ensure that employees followed IRS procedures. Allowing the EIC without sufficient documentation may result in lost revenue to the IRS by taxpayers receiving an EIC when they may not be entitled to it.

Recommendations

8. The IRS should establish minimum standards for auditors for determining the extent of source documents required to allow child-related EIC and children claimed as exemptions.

Management's Response: Management responded, "We revised the IRM to include guidelines for EITC examiners, and they must know the tax law that relates to the various programs. Training packages for the applicable tax law allowing deductions and credits are also available to the EITC examiners. Remote Exam conducts performance reviews of the centers to ensure the IRM and tax laws are followed. We conducted and videotaped a national train the trainer class that was provided to all centers to ensure consistency in training. Examiners have access to Publications 17 and 596, and

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IRS Tax Code and Regulations through SERP.

Examiners must review all documentation, consider the facts and circumstances on each case, and use sound judgment to make the proper determination.”

9. The IRS should emphasize the procedures to send Recertification Program claims to the Examination function.

Management’s Response: Management responded, “We will update IRM 21.6.3.4.2.7.15 to emphasize procedures for the Recertification Program for Customer Account Service employees.”

Taxpayer Correspondence Could Be Improved

Correspondence sent to taxpayers did not fully explain how the Program worked.

Correspondence used in the Recertification Program did not clearly explain how the Program worked or what was required for the taxpayer to be recertified. Some of the letters were incomplete or inaccurate, while other letters should not have been sent at all. Additionally, letters were not sent to advise taxpayers that they might be entitled to income-only EIC.

Some of the letter problems occurred because the Recertification Program did not adequately distinguish between the two ways taxpayers could qualify for the EIC. In addition, requests for computer programming for letter issuance did not always clearly identify what was needed to fully address all EIC recertification issues.

Correspondence used in the Recertification Program should clearly explain what taxpayers have to do to prove their EIC eligibility, be accurate, and explain the different ways taxpayers can qualify for the EIC. Otherwise, it is difficult for taxpayers to comply with EIC requirements, unnecessary taxpayer contacts may result, and some taxpayers will not receive their EIC.

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The letter sent to taxpayers when their EIC was initially denied could have better educated them about the recertification process

After the IRS completed the audits that denied the EIC, taxpayers were sent a letter that stated the IRS was required “to also deny the credit for subsequent years unless you provide information showing you are entitled to the credit.” The next paragraph stated: “You must, therefore, complete and attach Form 8862, Information To Claim Earned Income Credit After Disallowance, to the next federal tax return on which you claim the EIC. If you claim the credit and attach the Form 8862, we will determine if you are entitled to the credit.”

The initial letter sent to taxpayers when the EIC is denied needs to be improved to better educate taxpayers.

This letter would have been sent to an estimated 336,000 taxpayers as of September 30, 1999. While this letter did state that the taxpayer should file a Form 8862, the letter could be improved to better educate the taxpayers. For example, the letter does not include the following types of information:

- Additional documentation may be required to substantiate their claim for the EIC. The taxpayers may conclude from the IRS’ letter that only filing Form 8862 will automatically qualify them for the EIC. For example, in our closed audit sample, we identified 35 of 69 cases (51 percent) where taxpayers who filed Forms 8862 simply agreed with the proposed assessments without sending any of the requested documentation.
- The reason the EIC is being denied.
- The taxpayer may be entitled to income-only EIC if child-related EIC has been denied.
- The taxpayers need to file Forms 8862 with their subsequent year returns when claiming income-only EIC.

If this letter is not changed, taxpayers may continue to be confused about the recertification process. For example, approximately 16,000 taxpayers subject to recertification claimed income-only EIC on their 1998 tax returns. However, 12,000 had the EIC denied

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during return processing because the taxpayers did not submit Forms 8862. The reasons for this condition may have been that the letter did not specifically state Form 8862 was required for income-only EIC or that the letter did not include a blank Form 8862.

The letter sent to taxpayers who did not file Forms 8862 was incomplete

When taxpayers failed to submit Forms 8862 with their next tax returns claiming the EIC, their credits were denied. The IRS sent these taxpayers letters advising them that their credits were denied and the reasons for the denials. This letter would have been sent to an estimated 55,000 taxpayers as of September 30, 1999. Similar to the letter discussed immediately above, this letter also implied that filing the Form 8862 would recertify the taxpayer.

The letter sent to taxpayers who were denied the EIC during initial processing because they did not include Forms 8862 did not provide a blank Form 8862 as stated in the letter.

The letter stated: “We cannot allow your Earned Income Credit. We have no record of receiving a Form 8862 from you to recertify that you are eligible for the credit. You need to file a Form 8862, Information To Claim Earned Income Credit After Disallowance. For your convenience, we have included a Form 8862 with this notice.” However, the IRS did not enclose the Form 8862 when the letter was mailed. On March 15, 2000, we advised the IRS of this condition and it corrected this omission.

Letters sent to taxpayers explaining that their EIC claims were being allowed could be improved

The IRS sent one of three different letters to taxpayers advising them that their EIC claims were being allowed. How the IRS closed the taxpayer’s case determined which letter he/she received. For example:

- The first letter⁵ was sent if the EIC was allowed without an audit. IRS records indicate approximately 6,600 of these letters were sent from January 2000 through April 2000. This letter was specifically designed for the Recertification Program

⁵ Computer Paragraph 76.

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and was new for Calendar Year 2000. The EIC may be allowed without an audit for reasons such as taxpayers claiming income-only EIC.

- The second letter⁶ was sent if the audit was closed prior to issuance of the certified letter previously mentioned in this report. The third letter⁷ was sent if the audit was closed after issuance of the certified letter. We estimate that 3,800 taxpayers would have received 1 of these 2 letters for TY 1998 as of September 30, 1999.

Letters sent to taxpayers informing them that their EIC had been allowed did not inform them they were recertified and no longer had to file Forms 8862.

Each of these letters indicated that no changes were made to the taxpayers' returns and that no further actions were required by the taxpayers. Two of the letters were "general purpose" letters not designed specifically for the Recertification Program. However, none of the three letters informed taxpayers that they were recertified. As a result, the taxpayers may continue to unnecessarily file Forms 8862 with future returns.

Additionally, the letter specifically developed for the Recertification Program might cause unnecessary taxpayer contacts with the IRS.

- The letter was sent to some taxpayers who filed Forms 8862 but did not claim the EIC or had their EIC claims denied during initial return processing.
- The letter advised taxpayers that they should receive any refunds due within 8 weeks. However, these taxpayers should have already received their refunds or should have received the refunds the same week the letters were sent.

Some taxpayers were not informed that they might qualify for income-only EIC

When returns without recertification indicators were filed without claiming income-only EIC, the IRS notified certain taxpayers that they might qualify to receive the credit. These taxpayers were sent letters

⁶ Letter 3070.

⁷ Letter 645.

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with several questions to determine whether they qualified for the credit.

However, these letters were not sent to taxpayers whose tax accounts had recertification indicators. We estimate that as of September 30, 1999, over 6,000 taxpayers who may qualify for income-only EIC did not receive this letter. This action would prevent some qualified taxpayers from receiving income-only EIC. For example, although taxpayers had child-related EIC denied during audits, the taxpayers might qualify for income-only EIC in subsequent years. This would include taxpayers who subsequently meet the age, income, residency, and other qualification requirements.

Recommendations

10. The IRS should revise letters sent to taxpayers in the Recertification Program to ensure letter accuracy and to better explain the Program and should revise computer programming to ensure only appropriate letters are generated.

Management's Response: Management responded, "On September 21, 2000, we revised Letter 3094 to inform taxpayers that additional documentation may be required to substantiate their claims for EITC when they file Form 8862 following disallowance. In addition, we designed a letter, CP 75A, specifically for the Recertification Program, which tells the taxpayer their refund will be delayed. We have implemented a program change to suppress the CP 75A when the taxpayer has a balance due on the original filing."

Office of Audit Comment: Management's response did not address four of the six letters discussed in the body of the report. The letters not addressed include three letters that should inform taxpayers that they have been recertified, and one letter that should inform taxpayers additional documentation may be required to substantiate their claim (similar to Letter 3094).

11. The IRS should notify potentially qualified taxpayers subject to recertification that they might be entitled to income-only EIC. Any corrective action

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should take into consideration the rules for taxpayers previously denied the EIC due to reckless or intentional disregard for the law or fraud.

Management's Response: Management responded, "We revised Letter 3094 to tell taxpayers they may qualify for income-only EITC even though child-related EITC was denied."

The Internal Revenue Service Could Enhance the Recertification Program

Under current regulations and procedures, some taxpayers could be considered recertified without having to provide child-related EIC documentation.

The IRS could improve the Recertification Program to better protect revenue, while providing more consistent taxpayer treatment. Specifically, taxpayers who receive income-only EIC when child-related EIC had been previously denied should not be considered recertified.

In March 2000, the IRS issued procedures stating that qualified taxpayers who claimed income-only EIC and filed Forms 8862 would be considered recertified. The prior procedures did not address income-only EIC claims. However, the regulations for recertification and the March 2000 recertification procedures did not adequately distinguish among the different ways taxpayers could qualify for the EIC and will cause the following conditions to occur:

- Taxpayers may not be recertified for the reason their EIC was initially denied. For example, a taxpayer's child-related EIC was initially denied during an audit. The next year, this taxpayer files a return claiming income-only EIC and includes a Form 8862. Even though the taxpayer has not proven he/she is eligible for the child-related EIC, the IRS removes the recertification indicator.
- Taxpayers may now be allowed child-related EIC on subsequent tax returns without ever providing child-related EIC documentation.
- Taxpayers could now receive approximately \$3,800 in child-related EIC when they had been

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recertified based on receiving a maximum of approximately \$340 for income-only EIC.

We estimate 5,200 taxpayers had income-only EIC allowed for TY 1998 returns as of September 30, 1999. Recertifying these taxpayers may increase non-compliance and reduce revenue. (Example 5 in Appendix V illustrates this condition.)

Recommendation

12. To increase revenue protection, the IRS should consider changing the Recertification Program regarding when taxpayers are recertified. If this recommendation is adopted, the IRS should make a business decision as to what actions are necessary for taxpayers to receive income-only EIC after child-related EIC has been denied. Any changes should take into consideration the rules for taxpayers previously denied the EIC due to reckless or intentional disregard for the law or fraud.

Management's Response: Management responded that the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) will address this recommendation and its related outcome measure.

Office of Audit Comment: As of December 20, 2000, Counsel had not provided an official response.

Conclusion

In response to legislation requiring the IRS to verify certain taxpayers' eligibility for the EIC, the IRS designed and implemented the EIC Recertification Program. While the Program prevented some taxpayers from improperly receiving the EIC, the IRS needs to improve the Program to meet its objective of protecting revenue and taxpayer rights with the least amount of burden to the taxpayers.

Detailed Objective, Scope, and Methodology

Our overall objective was to determine whether the Internal Revenue Service (IRS) effectively addressed legislation requiring taxpayers whose Earned Income Credit (EIC) is denied during an audit to prove their eligibility for the credit before they receive it again. To accomplish this objective, we determined whether the IRS:

- Established an effective recertification process to address the legislation and clearly defined the process in regulations and procedures.
- Used correspondence that clearly communicated with taxpayers about this process.
- Established accurate indicators on taxpayers' accounts that prevented taxpayers from receiving the EIC and then removed the indicators after taxpayers proved their eligibility.
- Processed taxpayers' EIC eligibility claims in a timely and accurate manner.

We obtained a sample of the IRS Individual Masterfile¹ taxpayer data based on the last digit of the Social Security Number (SSN). Using the last digit of the SSN provided us with a sample of 10 percent of the accounts that was representative of the entire population. This database identified those taxpayers whose Tax Year (TY) 1997 or 1998 returns had the EIC denied in whole or in part by the Examination function and those with 1998 return transactions to suspend any refunds. Our 10 percent database reflected various tax account and tax return information for TY 1997 and 1998 returns. We used this database to query for various information and to select samples of cases to review. Nationwide estimates appear in the report only when we analyzed 100 percent of the 10 percent database. We multiplied the results by 10 to produce the national estimates.

Our sample was taken from an existing data file that contained all Individual Masterfile records as of cycle² 199939 (as of September 30, 1999) that had the same last digit in the SSN. To ensure that this file represented 10 percent of the population of taxpayer accounts, we analyzed all taxpayer records, using our prior selection criteria, for cycle 199947 (as of November 25, 1999). An analysis of the cycle 199947 information showed that the sample based on the same last digit of the SSN was 10 percent. If there was no material change in the audit population between these 2 cycles, and we have no reason to

¹ The Internal Revenue Service database that maintains transactions or records of individual tax accounts.

² One week's processing at the processing centers. The cycle is expressed by a 6-digit code. The first four digits are the processing year. The last two digits are the processing week in that year.

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believe that there was, an assumption can be made that our sample represents 10 percent of the population.

- I. We determined whether the recertification process was clearly defined in IRS regulations and procedures.
 - A. We evaluated the regulations issued to implement the EIC recertification-related section of the Taxpayer Relief Act of 1997.³
 - B. We evaluated the IRS procedures for the processing center Examination functions for Calendar Years 1999 and 2000 and had discussions with National Headquarters personnel to determine the IRS' intent regarding the Recertification Program and what constituted recertification.
- II. We determined whether IRS communications with taxpayers clearly informed and educated the taxpayers regarding the recertification process.
 - A. We evaluated the letter sent to taxpayers by the Examination function when the EIC was denied during an audit.
 - B. We evaluated the adequacy of letters sent to taxpayers when the IRS denied the EIC because taxpayers did not submit Information To Claim Earned Income Credit After Disallowance (Form 8862) with their tax returns. We also determined whether the IRS sent taxpayers blank Forms 8862.
 - C. We evaluated the various letters sent to taxpayers when the Examination function determined that the EIC would be allowed to determine how the IRS informed taxpayers that their EIC eligibility had been restored.
 - D. We evaluated letters sent to taxpayers to advise them that their refunds would be delayed.
- III. We determined whether the IRS had properly established recertification indicators on accounts and properly removed the recertification indicator when the accounts had been recertified.
 - A. We queried our 10 percent database to identify the accounts where the IRS had denied the EIC in whole or in part on TY 1997 or 1998 returns to determine whether the recertification indicators had posted to the IRS Individual Masterfile on each of the accounts.
 - B. We determined whether the recertification indicator was accurately removed when appropriate.

³ Taxpayer Relief Act of 1997, 26 U.S.C. § 24.

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1. We queried our database and analyzed tax account information for taxpayers who did not have the recertification indicator removed when the IRS allowed the EIC.
 2. We queried our database and analyzed tax account information for taxpayers who had the recertification indicator removed in error because taxpayers had not been recertified.
- IV. We determined whether the IRS timely and accurately processed recertification claims.
- A. We randomly selected and reviewed a sample of 104 TY 1998 tax returns being audited at the Austin, Fresno, and Memphis Processing Centers for the following:
 1. Whether the IRS timely started the audits.
 2. Whether the IRS timely sent taxpayers the initial and certified letters.
 3. Whether the IRS timely considered and responded to taxpayer replies to IRS letters.
 4. Whether the audits were controlled with the correct project codes (these codes are used in part for inventory tracking purposes).
 5. Whether National Headquarters and processing center employees tracked audit timeliness, whether the processing centers had been asked to explain why audits were not timely, and what corrective actions had been taken.
 - B. We evaluated the adequacy of the Examination function screening of weekly listings used to identify returns with suspended refunds. These listings are used to determine whether returns should be audited and whether suspended refunds should be released.
 1. We determined the adequacy of procedures issued to the processing centers for screening the weekly listings.
 2. We randomly sampled 200 tax accounts from TY 1998 returns that did not have audits in process as of September 30, 1999, and determined whether the refunds had been timely issued.
 - C. We reviewed a random sample of 69 closed returns audited by the Austin, Fresno, and Memphis Processing Centers' Examination functions to determine whether the IRS was consistent in the evidence required from taxpayers to recertify the EIC and whether the IRS allowed the EIC without sufficient source documentation provided by the taxpayers.
 - D. We reviewed a random sample of 37 cases closed by the IRS with the EIC allowed without audits at the Austin, Fresno, and Memphis Processing

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Centers. We evaluated the case files to determine whether the EIC had been allowed with the required Examination function approval and with the required documentation.

- V. We determined the impact of procedures on taxpayers who claimed the income-only EIC on TY 1998 returns. We queried our 10 percent database and identified taxpayers who claimed the income-only EIC. We then determined which taxpayers had the EIC disallowed during initial return processing because they had not filed the Form 8862 and which returns were sent to the Examination function for the EIC-related review.

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Outcome Measures

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. These benefits will be incorporated into our Semiannual Report to the Congress.

Finding and recommendation (page 5):

The Internal Revenue Service (IRS) did not always remove the recertification indicators accurately. The IRS allowed the EIC but did not remove the recertification indicator for an estimated 11,400 taxpayers nationwide. Additionally, the IRS erroneously removed the recertification indicator for an estimated 4,100 taxpayers nationwide. The IRS should remove the recertification indicators from those accounts where taxpayers have proven their Earned Income Credit (EIC) eligibility and should improve its quality review process to help ensure employees remove indicators when appropriate.

Type of Outcome Measure:

- Taxpayer Rights and Entitlements - Potential
- Increased Revenue/Revenue Protection - Potential

Value of the Benefit:

Taxpayers should receive the EIC and only the EIC they are entitled to receive in subsequent years. We estimate 11,400 taxpayers had the EIC allowed but did not have the recertification indicators removed. Correctly removing indicators would allow those taxpayers entitled to the EIC to receive the EIC at the time their returns are filed rather than later having to contact the IRS to receive their EIC. Correctly removing the indicators would also prevent delayed refunds. Preventing the incorrect removal of indicators, which included an estimated 4,100 taxpayers, will protect revenue.

Methodology Used to Measure the Reported Benefit:

Our database contained 10 percent of the national recertification cases as of September 30, 1999 (cycle 199939). We analyzed 100 percent of the 10 percent database to arrive at the number of taxpayers who had the recertification indicators not removed when the EIC was allowed and those taxpayers who had the indicators incorrectly removed. Our estimates are based on the number of cases meeting our criteria from the 10 percent database multiplied by 10 to obtain the national estimates.

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Finding and recommendation (page 9):

Some suspended refunds were not released timely. In our sample of 200 accounts with actions to suspend any refunds, we identified that the IRS did not release refunds timely for 86 (43 percent) accounts. The IRS should identify and resolve recertification accounts with incorrectly suspended refunds and modify computer programs to ensure weekly listings include all applicable taxpayer accounts with suspended refunds.

Type of Outcome Measure:

- Taxpayer Rights and Entitlements - Actual

Value of the Benefit:

Adopting our recommendations will help ensure that taxpayers timely receive their refunds. For example, a total of 86 taxpayers from our sample of 200 did not timely receive their refunds.

Methodology Used to Measure the Reported Benefit:

Our database contained 10 percent of the national recertification cases as of September 30, 1999. We took a random sample and evaluated taxpayer account information to determine whether the IRS timely issued refunds. Although the sample was random, we are not projecting the number of taxpayers who would have had delayed refunds.

Finding and recommendation (page 11):

Recertification audits were not always completed timely. We reviewed 104 EIC recertification audits and identified 59 (57 percent) that had not been timely processed. The delays ranged from 2 weeks to 29 weeks and averaged 8 weeks. The IRS should ensure that inventory reports are effectively used to monitor and identify processing delays, timely feedback is provided to offices where delays occur, and correct project codes are used to identify recertification audits.

Type of Outcome Measure:

- Taxpayer Burden - Actual

Value of the Benefit:

Adopting our recommendations will help ensure that the IRS timely completes audits. For example, a total of 59 taxpayers in our sample of 104 did not have timely IRS actions during audits.

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Methodology Used to Measure the Reported Benefit:

Our database contained 10 percent of the national recertification cases as of September 30, 1999. From our database, we randomly sampled 104 EIC recertification audits at 3 processing centers. We used IRS time frame criteria to determine whether audits were completed timely. Although the sample was random, we are not projecting our results because the sample was not statistically valid.

Finding and recommendation (page 13):

Not all recertification determinations were accurate. We identified 40 returns where the IRS allowed child-related EIC totaling approximately \$82,000 without sufficient documentation provided by taxpayers. These 40 returns included 22 returns from our sample of 69 returns that had been audited and 18 returns from our sample of 37 returns that had not been audited. The IRS should establish minimum standards for auditors for determining the extent of source documents required to allow child-related EIC and children claimed as exemptions. In addition, the IRS should ensure procedures are followed and Recertification Program claims are sent to the Examination function.

Type of Outcome Measure:

- Increased Revenue/Revenue Protection - Actual

Value of the Benefit:

Ensuring recertification determinations are accurate would have prevented 40 taxpayers, in our samples totaling 106 returns, from receiving the EIC they might not have been entitled to. Establishing minimum standards for documentation to determine whether the EIC should be allowed will help ensure consistency and accuracy in audit determinations.

Methodology Used to Measure the Reported Benefit:

Our database contained 10 percent of the national recertification cases as of September 30, 1999. From our database, we took 2 random samples and reviewed the related tax returns for 3 of the 10 processing centers. The samples included 69 Tax Year (TY) 1998 returns that had been audited and 37 TY 1998 returns with recertification indicators that had not been audited. We discussed the accuracy of the EIC allowance with the three processing centers. Although the samples were random, we are not projecting our results because the samples were not statistically valid.

Finding and recommendation (page 17):

Taxpayer correspondence could be improved. Correspondence to taxpayers about the recertification process was not always clear or was not sent. The IRS should revise the letters to ensure accuracy, better explain the Program, and inform taxpayers what future actions may be required.

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Type of Outcome Measure:

- Taxpayer Burden - Potential
- Taxpayer Rights and Entitlements - Potential

Value of the Benefit:

Changing the letters would help educate taxpayers about the recertification process, resulting in taxpayers obtaining a better understanding of the recertification process and a decrease in unnecessary audits. Additionally, sending letters to advise taxpayers that they might be entitled to income-only EIC will help educate taxpayers and help ensure taxpayers receive the EIC to which they are entitled. The following numbers of taxpayers are affected:

- The letter sent to taxpayers when the EIC is initially denied could better educate taxpayers regarding the recertification process. We estimate that 336,000 taxpayers received this letter as of September 30, 1999.
- The letter sent to taxpayers who did not file Information To Claim Earned Income Credit After Disallowance (Form 8862) when required did not educate taxpayers and did not include a blank Form 8862. We estimate that 55,000 taxpayers received this letter as of September 30, 1999.
- The letter sent to taxpayers explaining their EIC is being allowed could be improved. IRS records indicate that, during the period January through April 2000, approximately 6,600 letters were sent when the EIC was being allowed without an audit of the related tax returns. We estimate that, as of September 30, 1999, 3,800 taxpayers received 1 of the 2 letters used to advise taxpayers their EIC was being allowed during an audit.
- The letter explaining that taxpayers might be entitled to receive income-only EIC was not sent to taxpayers with recertification indicators on their accounts. We estimate this affected over 6,000 taxpayers as of September 30, 1999.

Methodology Used to Measure the Reported Benefit:

Our database contained 10 percent of the national recertification cases as of September 30, 1999. As per our database, 33,600 taxpayers had some or all of their EIC denied by IRS audits of their TY 1997 or 1998 returns. Additionally, 5,500 taxpayers had their EIC denied because they did not file Form 8862 with their TY 1998 returns, and 380 taxpayers had audits of their TY 1998 returns where the EIC claimed had been allowed. Our figures for the number of letters are based on the number of cases meeting our 10 percent criteria multiplied by 10 to obtain the national estimates. The number of letters not sent to advise taxpayers they might be entitled to income-only EIC is based on the 1,500 taxpayers in our 10 percent database that met income requirements to

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potentially receive the letter. We checked taxpayer account information to determine whether they met the age criteria to receive the letter and multiplied by 10 to obtain the national estimate.

Finding and recommendation (page 22):

The IRS could enhance the Recertification Program. Recertification Program procedures and the recertification indicators are not based on the reasons the EIC is denied. Taxpayers who receive income-only EIC when child-related EIC had been previously denied should not be considered recertified. The IRS should consider changing the Recertification Program regarding when taxpayers are considered recertified.

Type of Outcome Measure:

- Increased Revenue/Revenue Protection - Potential

Value of the Benefit:

Taxpayers would not be allowed to receive the maximum of approximately \$3,800 in child-related EIC based solely on the fact they received the maximum of approximately \$340 in income-only EIC when the taxpayers were originally denied child-related EIC. We estimate that 5,200 taxpayers had income-only EIC allowed for their TY 1998 returns as of September 30, 1999.

Methodology Used to Measure the Reported Benefit:

We analyzed the regulations and the EIC procedures for the Recertification Program and identified the potential for income-only EIC taxpayers to be considered recertified, allowing them to receive child-related EIC without providing any documentation to prove eligibility for the child-related EIC that they had been previously denied. Our database contained 10 percent of the national recertification cases as of September 30, 1999. We analyzed 100 percent of the 10 percent database to arrive at the number of taxpayers in our sample who had income-only EIC allowed on their 1998 returns. Our estimate is based on the number of cases meeting our criteria from the 10 percent database multiplied by 10 to obtain the national estimate.

Case Examples

Example 1 – The Internal Revenue Service (IRS) Did Not Always Remove Recertification Indicators After Allowing the Earned Income Credit (EIC)

A taxpayer was denied the EIC totaling \$3,800 because the IRS did not remove the recertification indicator. The taxpayer was denied the EIC on his/her 1997 return. The IRS later allowed the taxpayer's 1997 EIC but did not remove the indicator. Because the indicator had not been removed, the IRS also denied the taxpayer's EIC claims for Tax Years (TY) 1998 and 1999.

Example 2 – Some Suspended Refunds Were Not Released Timely

A couple with reported income of \$14,000 and 1 child did not receive their 1998 refund of \$2,900 for 11 months, even though their EIC was allowed for TY 1997.

Example 3 – Recertification Audits Were Not Always Timely Processed

A single taxpayer with 1 child and claiming income of approximately \$23,000 timely filed his/her 1998 return, along with Information To Claim Earned Income Credit After Disallowance (Form 8862). The taxpayer did not receive his/her \$3,400 refund for 8 months because of untimely audit actions on his/her 1998 return. The IRS issued the initial letter for the taxpayer's 1998 audit during early April 1999 requesting the supporting EIC documentation. The taxpayer submitted all requested EIC documentation to the IRS within 2 weeks. However, the IRS issued a second letter 2 months later, requesting the same documentation. The taxpayer responded again with a copy of the documentation previously submitted.

During mid-August 1999, the IRS issued a certified letter to the taxpayer. The taxpayer responded for a third time with a copy of the documentation previously submitted. Two months later, the IRS informed the taxpayer that the EIC claimed on the 1998 return would be allowed and the case was closed. However, the taxpayer's refund was not issued until the end of December, 8 months after the IRS received the taxpayer's first response.

Improvements Are Needed in the Earned Income Credit Recertification Program

Example 4 – Sample Where EIC Was Allowed Without Audits

A single taxpayer with 2 children received an EIC of approximately \$1,400 without any supporting documentation and without the required Form 8862. After receiving a letter from the IRS that the EIC claim was denied and that the taxpayer now owed money to the IRS, the taxpayer responded by sending in a copy of the return. The IRS simply allowed the EIC based on this copy of the return.

Example 5 – The IRS Could Enhance the Recertification Program

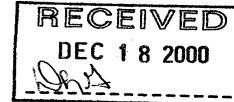
A single taxpayer received a total of approximately \$4,500 in child-related EIC for TYs 1998 and 1999 after receiving the income-only EIC for 1998 and having the indicator removed. The taxpayer claimed the EIC for one child on the 1997 return, but the EIC was denied due to an audit. On the 1998 return, the taxpayer claimed and received income-only EIC, and the IRS removed the recertification indicator. The taxpayer filed the 1999 return claiming the EIC for the same child denied on the 1997 return and was given the EIC without an audit. The taxpayer then filed an amended return for the 1998 return and received the child-related EIC.

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
ATLANTA, GA 30308

DEC 15 2000



MEMORANDUM FOR TREASURY INSPECTOR GENERAL FOR TAX
ADMINISTRATION

FROM:

John M. Dalrymple
John M. Dalrymple
Commissioner, Wage and Investment Division

SUBJECT:

Draft Report - "Improvements are Needed in the Earned
Income Credit Recertification Program
(Audit #1999-40-107)

We appreciate the opportunity to respond to your draft report, "Improvements are Needed in the Earned Income Credit (EITC) Recertification Program." The IRS' Recertification Program has reduced the amount of ineligible EITC claims allowed. Your report recognized we properly placed recertification indicators on over 336,000 taxpayer accounts while denying, during audits, an estimated \$620 million in EITC claims as of September 30, 1999. We would also like to note the amount of revenue we saved due to Math Error procedures. For processing year 1999, we stopped 104,000 returns claiming EITC incorrectly at the time of filing. Using an average refund of \$1,845 per return, the IRS saved an additional \$192 million due to the Math Error recertification process, bringing the total amount of revenue saved to \$812 million. A research project on recertification cases indicated 34 percent of these filers will not repeat their behavior in the future. We believe an additional 36 percent of these filers were successfully educated that they do not have a filing obligation. The \$812 million savings does not include the cost savings represented by these taxpayers.

We previously discussed with your auditors the methodology used in this audit to determine the number of taxpayers whose recertification indicators were not reversed after examination. In September 2000, we requested a computer extract to capture the number of taxpayers whose indicator was not reversed after an examination. Our extract identified 1,646 taxpayers nationwide.

We concur with your outcome measures related to the timely release of suspended refunds, timely completion of recertification audits, accurate recertification determinations, and improving correspondence to taxpayers. We concur with your outcome measure related to accurately removing recertification indicators to the extent identified by our computer extract.

Improvements Are Needed in the Earned Income Credit Recertification Program

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Our comments on your specific recommendations are as follows:

IDENTITY OF RECOMMENDATION 1

The IRS should ensure that the recertification indicators on taxpayers' accounts are accurate. Accordingly, it should remove indicators from taxpayers' accounts if they have proven their EITC eligibility.

ASSESSMENT OF CAUSE

A limited number of employees did not have all the procedures concerning the recertification program.

CORRECTIVE ACTION

On January 1, 2000, we formalized EITC recertification procedures by including them in the IRM that is available to all EITC examiners on the Servicewide Electronic Research Program (SERP).

IMPLEMENTATION DATE

Completed - January 1, 2000

RESPONSIBLE OFFICIAL

Assistant Commissioner (Customer Service)

CORRECTIVE ACTION MONITORING PLAN

Not Applicable

IDENTITY OF RECOMMENDATION 2

The IRS should improve its quality review process to help ensure employees remove indicators when appropriate.

ASSESSMENT OF CAUSE

Our quality review process did not show any problems with removing the recertification indicator.

CORRECTIVE ACTION

We conducted a quality review of 138 closed cases per month per site during Fiscal Year 2000. The total number of cases reviewed nationwide was approximately 16,500 or 2.9 percent of the total EITC closings. As of September 30, 1999, 572,695 EITC cases were closed nationwide and only 8,101 (1.4 percent) were recertification cases. As evidenced by our review, it would not be unusual that only five errors were identified nationwide. Therefore, we will not change our quality review process at this time, but rather we will rely on our revised procedures and training to ensure employees remove indicators when appropriate. If future reviews indicate problems, we will reconsider our quality review procedures.

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IMPLEMENTATION DATE

Not Applicable

RESPONSIBLE OFFICIAL

Not Applicable

CORRECTIVE ACTION MONITORING PLAN

Not Applicable

IDENTITY OF RECOMMENDATION 3

The IRS should clarify the March 2000 procedures to specifically instruct employees as to what information and actions are needed to prove taxpayers are qualified to receive the income-only EIC. These procedures should also be clarified to ensure that taxpayers are not considered recertified when they file Forms 8862 but do not claim or receive an EIC.

ASSESSMENT OF CAUSE

Service Center Examination Branch procedures were not adequate to ensure all qualified taxpayers received income-only EITC.

CORRECTIVE ACTION

We revised the March 2000 procedures and included them in the December 2000 IRM to specifically instruct employees as to what information and actions are needed to prove taxpayers are qualified to receive the income-only EITC. We also revised Letter 3094, EITC Credit Denied, in October 2000 to explain to taxpayers how to claim income-only EITC.

IMPLEMENTATION DATE

Completed - December 1, 2000

RESPONSIBLE OFFICIAL

Director, Compliance Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

Not Applicable

IDENTITY OF RECOMMENDATION 4

The IRS should identify and resolve recertification accounts with incorrectly suspended refunds.

ASSESSMENT OF CAUSE

Forty-three percent of the accounts reviewed did not have refunds released timely.

Improvements Are Needed in the Earned Income Credit Recertification Program

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CORRECTIVE ACTION

We requested a one-time extract to identify recertification accounts with suspended refunds and issued a Taxpayer Service Electronic Bulletin Board (TEBB) with instructions to exam personnel for working these cases. Additionally, a Request for Information Services (RIS) has been approved and tested for a monthly extract beginning January 1, 2001, of nonreversed refunds. This listing will be forwarded on a monthly basis to each Examination Branch for action and resolution.

IMPLEMENTATION DATE

Proposed - January 1, 2001

RESPONSIBLE OFFICIAL

Director, Compliance Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

National Office will receive a monthly report detailing each center's volume.

IDENTITY OF RECOMMENDATION 5

The IRS should modify computer programs to ensure that the weekly listings include all applicable taxpayer accounts with suspended refunds.

ASSESSMENT OF CAUSE

The weekly listings used to determine whether to release the refunds or to conduct an audit did not contain all the accounts with suspended refunds because we did not properly code the taxpayers' accounts to appear on the listings.

CORRECTIVE ACTION

We corrected the programming by automating transaction code (TC) 424 and TC 810 on Pick-up cases. This will ensure weekly listings contain all accounts with suspended refunds. Instructions to Examination personnel to work the list within 5 business days were issued through a TEBB and are in IRM 21.8 dated December 1, 2000.

IMPLEMENTATION DATE

Completed - December 1, 2000

RESPONSIBLE OFFICIAL

Director, Compliance Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

National Office will receive a monthly report detailing each center's volume.

IDENTITY OF RECOMMENDATION 6

The IRS should ensure that inventory reports are effectively used to monitor and identify processing delays and provide timely feedback to offices where delays occur.

ASSESSMENT OF CAUSE

TIGTA identified timeliness problems with initial letters, certified letters, and responses to taxpayer correspondence.

CORRECTIVE ACTION

The monthly extract detailed in the Corrective Action under Recommendation 4 will assist examiners in identifying and resolving processing delays. National Office will perform monthly oversight to ensure feedback is provided to offices where delays occur. Other monitoring tools are already in place. They include:

- The Report Generating Software (RGS) Case Summary Records are used to track cases. Managers have access to case summary records, can monitor individual employees and overall group inventory, and ensure that audits were completed timely.
- Status workload reports generate every 2 weeks in each center. The parameters used on these reports allow management to timely control and move inventory.
- Field Operations and National Office analysts perform monthly inventory oversight.

IMPLEMENTATION DATE

Proposed - January 1, 2001

RESPONSIBLE OFFICIAL

Director, Compliance Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

National Office will receive a monthly report detailing each center's volume.

IDENTITY OF RECOMMENDATION 7

The IRS should use the correct project codes to identify recertification audits.

ASSESSMENT OF CAUSE

Almost 30 percent of the cases in the sample pulled by the auditor were not controlled with the correct project codes (used to identify recertification audits).

CORRECTIVE ACTION

Project codes are automatically entered on master file when a return is filed claiming EITC and Form 8862 is attached. The IRS has corrected the programming on Pick-Up cases by automating TC 424, TC 810, and the project code, which will ensure all cases contain the correct code.

Improvements Are Needed in the Earned Income Credit Recertification Program

11/20/20

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IMPLEMENTATION DATE

Completed - December 1, 2000

RESPONSIBLE OFFICIAL

Director, Compliance Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

Reports will generate at both the national and service center level.

IDENTITY OF RECOMMENDATION 8

The IRS should establish minimum standards for auditors determining the extent of source documents required to allow child-related EIC and children claimed as exemptions.

ASSESSMENT OF CAUSE

The IRS did not always ensure taxpayers provided sufficient documentation before allowing EITC.

CORRECTIVE ACTION

We revised the IRM to include guidelines for EITC examiners, and they must know the tax law that relates to the various programs. Training packages for the applicable tax law allowing deductions and credits are also available to the EITC examiners. Remote Exam conducts performance reviews of the centers to ensure the IRM and tax laws are followed. We conducted and videotaped a national train the trainer class that was provided to all centers to ensure consistency in training. Examiners have access to Publications 17 and 596, and IRS Tax Code and Regulations through SERP.

Examiners must review all documentation, consider the facts and circumstances on each case, and use sound judgment to make the proper determination.

IMPLEMENTATION DATE

Completed - December 1, 2000

RESPONSIBLE OFFICIAL

Director, Compliance Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

The Quality Review process will identify deficiencies in training.

IDENTITY OF RECOMMENDATION 9

The IRS should emphasize the procedures to send Recertification Program claims to the Examination function.

Improvements Are Needed in the Earned Income Credit Recertification Program

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ASSESSMENT OF CAUSE

TIGTA determined IRS allowed child-related EIC totaling \$36,000 for 18 taxpayers without sufficient documentation. Only 3 of the 18 returns were sent to the Examination function.

CORRECTIVE ACTION

We will update IRM 21.6.3.4.2.7.15 to emphasize procedures for the Recertification Program for Customer Account Service employees.

IMPLEMENTATION DATE

Proposed - March 1, 2001

RESPONSIBLE OFFICIAL

Director, Customer Account Services Wage and Investment Division

CORRECTIVE ACTION MONITORING PLAN

Not Applicable

IDENTITY OF RECOMMENDATION 10

The IRS should revise letters sent to taxpayers in the Recertification Program to ensure letter accuracy and to better explain the Program and should revise computer programming to ensure only appropriate letters are generated.

ASSESSMENT OF CAUSE

The letters sent to taxpayers when EITC is denied can be improved to better educate taxpayers on the recertification process.

CORRECTIVE ACTION

On September 21, 2000, we revised Letter 3094 to inform taxpayers that additional documentation may be required to substantiate their claims for EITC when they file Form 8862 following disallowance. In addition, we designed a letter, CP 75A, specifically for the Recertification Program, which tells the taxpayer their refund will be delayed. We have implemented a program change to suppress the CP 75A when the taxpayer has a balance due on the original filing.

IMPLEMENTATION DATE

Completed - September 21, 2000

RESPONSIBLE OFFICIAL

Assistant Commissioner (Customer Service)

CORRECTIVE ACTION MONITORING PLAN

Not Applicable

IDENTITY OF RECOMMENDATION 11

The IRS should notify potentially qualified taxpayers subject to recertification that they might be entitled to income-only EIC. Any corrective action should take into consideration the rules for taxpayers previously denied the EIC due to reckless or intentional disregard for the law or fraud.

ASSESSMENT OF CAUSE

Letters were not sent to taxpayers who had recertification indicators on their accounts and who may be entitled to income-only EITC.

CORRECTIVE ACTION

We revised Letter 3094 to tell taxpayers they may qualify for income-only EITC even though child-related EITC was denied.

IMPLEMENTATION DATE

Completed - September 21, 2000

RESPONSIBLE OFFICIAL

Assistant Commissioner (Customer Service)

CORRECTIVE ACTION MONITORING PLAN

Not Applicable

IDENTITY OF RECOMMENDATION 12

To increase revenue protection, the IRS should consider changing the Recertification Program regarding when taxpayers are recertified. If this recommendation is adopted, the IRS should make a business decision as to what actions are necessary for taxpayers to receive income-only EITC after child-related EITC has been denied. Any changes should take into consideration the rules for taxpayers previously denied the EITC due to reckless or intentional disregard for the law or fraud.

The Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) is addressing this recommendation and its related outcome measure in a separate memorandum to TIGTA. They are responsible for addressing such changes to the recertification program as recommended by TIGTA.

If you have any questions or need additional information, please contact me, or members of your staff may contact William Zachery at (404) 338-7643 or Karen Montpetit at (631) 654-6532.